

# CHOICE OF ENTITY FOR A VENTURE CAPITAL START-UP: THE MYTH OF INCORPORATION

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## I. INTRODUCTION

Most tax professionals would advise entrepreneurs to commence their start-up business as a limited liability company (LLC), which, absent an election, is treated as a partnership for federal tax purposes. That advice reflects the notion that tax considerations are among the most important in choosing an entity form, and LLCs offer the advantages of partnership treatment yet provide the limited liability of corporations.<sup>1</sup>

In the high-tech start-up industry, however, entrepreneurs are often advised to begin business as a corporation, albeit sometimes an S corporation if the entity can qualify. This advice is based largely on several perceived operating advantages which are either more easily achieved by or require the corporate form.<sup>2</sup>

Most important of these perceived advantages, perhaps, is the need for the corporate form to achieve the most sought after exit strategies of a public offering or a tax-free acquisition by a public company, sometimes referred to as the "home run" exit strategies. Another perceived advantage of the corporate form is its facility to allow for stock options to employees, giving them additional work incentives through compensation that does not deplete the start-up company's cash resources. Another commonly perceived corporate advantage lies in satisfying the desire of investors to invest in corporations rather than other types of entities. These investors may be early stage investors, sometimes referred to as "angel investors" or simply "angels," or later stage investors, sometimes referred to as "venture capitalists." Venture capitalists sometimes form investment funds with several participating investors, called "venture capital funds." Finally, advisors appear to view the tax advantages of LLCs as more theoretical than real, neither of great magnitude nor importance to any of the participants in the venture.

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<sup>1</sup>See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 2.05[2] (7th ed. 2001); BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 90.1 (Supp. 2001); STEPHEN A. LIND ET AL., *FUNDAMENTALS OF PARTNERSHIP TAXATION* 19-24 (5th ed. 1998); John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do,"* 78 TEX. L. REV. 885 (2000); Don W. Llewellyn & Anne O'Connell Umbrecht, *No Choice of Entity After Check-The-Box*, 52 TAX LAW. 1 (1998); John H. Matheson & Brent A. Olson, *A Call for a Unified Business Organization Law*, 65 GEO. WASH. L. REV. 1 (1996); William J. Rands, *Passthrough Entities and Their Unprincipled Differences Under Federal Tax Law*, 49 SMU L. REV. 15 (1995).

<sup>2</sup>See Joseph Bankman, *The UCLA Tax Policy Conference: The Structure of Silicon Valley Start-ups*, 41 UCLA L. REV. 1737, 1739 (1994). Bankman identified several of these perceived advantages from interviews with Silicon Valley executives and venture capitalists.

This article asserts that advisors who advise immediate incorporation are relying largely on myths that the corporation, rather than the LLC, is the more desirable entity for a start-up seeking venture capital funding. This article will review briefly the most important federal tax advantages enjoyed by the LLC over the corporation and then set forth, examine, and debunk the myths of incorporation.

## II. TAX CONSIDERATIONS IN CHOICE OF ENTITY, IN GENERAL

### A. *Net Profits*

The most salient aspect of partnership taxation, which includes the tax treatment of LLCs that are treated as partnerships for tax purposes, is the fact that only a single level of tax is incurred when operating in a partnership structure.<sup>3</sup> The partnership itself is not subject to tax.<sup>4</sup> Rather the structure involves what is generally referred to as pass-through treatment.<sup>5</sup> Thus, if a partnership has income, the income is taxed at the partner level only. And, if a partnership has losses, the losses pass through to the partners, to offset partners' other income (subject to outside basis limitations,<sup>6</sup> at-risk rules,<sup>7</sup> and passive activity loss rules<sup>8</sup>). In the discussion that follows, the terms partnership and limited liability company are used interchangeably.

In contrast to the single tax, pass-through character of partnership taxation, a corporation (other than an electing S corporation) is treated as an entity for tax purposes. As such, a corporation's income is subject to a corporate level tax,<sup>9</sup> and distributions of that income are subject, in general, to a shareholder level tax as dividend income,<sup>10</sup> unless otherwise excused under the Code.<sup>11</sup>

An S corporation<sup>12</sup> has features of both partnerships and C corporations. Like a partnership, an S corporation is generally not taxable and offers pass-through treatment to its shareholders.<sup>13</sup> But, like a C corporation, its transactions are

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<sup>3</sup>Although there may also be some Federal Insurance Contributions Act (FICA) benefits associated with the use of the S corporation structure that are not available to partnerships or LLCs, the treatment of LLCs under FICA remains unclear, pending finalization of proposed regulations. See Prop. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702 (1997); see also Thomas E. Fritz, *Flowthrough Entities and the Self-Employment Tax: Is It Time For a Uniform Standard?*, 17 VA. TAX REV. 811, 816 (1998).

<sup>4</sup>I.R.C. § 701.

<sup>5</sup>I.R.C. § 702.

<sup>6</sup>I.R.C. § 704(d).

<sup>7</sup>I.R.C. § 465.

<sup>8</sup>I.R.C. § 469.

<sup>9</sup>I.R.C. § 11.

<sup>10</sup>I.R.C. §§ 316, 61(a)(7).

<sup>11</sup>See, e.g., I.R.C. § 243.

<sup>12</sup>Several special requirements must be satisfied for a corporation to qualify as an S corporation, in addition to filing a timely election. These requirements include: (a) the limitation of shareholders to 75 shareholders; (b) only individuals (and certain trusts and estates) may be shareholders; (c) the S corporation cannot have a nonresident alien as a shareholder; and (d) the S corporation is limited to one class of stock. I.R.C. § 1361(b). Because of these statutory requirements, an S corporation is not suitable for many business situations, particularly those involving venture capital funding by venture capital fund partnerships or corporate venture capitalists.

<sup>13</sup>I.R.C. §§ 1363, 1366.

generally governed by Subchapter C.<sup>14</sup> As a result, certain corporation/shareholder transactions are subjected to immediate tax. In addition, S corporations with C corporation earnings and profits histories can be subject to a corporate level tax as well.<sup>15</sup> Because this article focuses on start-up situations, it will assume that any S corporation has no prior C corporation earnings and profits history, unless stated otherwise.

### B. *Net Losses*

The partnership/LLC structure also facilitates the pass-through of losses incurred in the business to the partners. Each partner includes on his tax return his distributive share of the partnership's losses from operations.<sup>16</sup>

In contrast, losses incurred by a corporation (other than an electing S corporation) remain in the corporation to be carried back or carried forward to the extent there is income to offset in past or future years.<sup>17</sup> But the losses are not available for use by the shareholders themselves. This carryover rule, however, is subject to some qualifications. The most important qualification for start-up companies is the application of the corporate change of ownership rules.<sup>18</sup> While in theory the loss carries over to offset future income of the corporation, the change of ownership rules could cause the loss to become useless after a few rounds of new equity financing, thereby potentially causing the corporate losses to be largely wasted if no income is earned by the corporation in the interim.<sup>19</sup>

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<sup>14</sup>I.R.C. § 1371(a).

<sup>15</sup>See, e.g., I.R.C. § 1374.

<sup>16</sup>I.R.C. § 702. It should be noted that it is by no means certain that the passed-through losses will be available immediately to offset the partners' other income. First, the partner to whom the losses have been allocated must have sufficient basis in his partnership interest. I.R.C. § 704(d). For these purposes (and explained more fully below), the partner's basis in his partnership interest ("outside basis") includes the partner's share of partnership liabilities. I.R.C. § 752 and the regulations thereunder. Second, the partner seeking to use the losses must be "at-risk" for the amount of the losses; in general, he must have invested the actual money or be personally liable for partnership liabilities so as to bear the economic burden of his share of the partnership's losses. See I.R.C. § 465(b)(6) but note the exception to this rule for qualified non-recourse financing of real estate. Third, even if, and to the extent that, the losses pass through after overcoming the hurdles described above, the partnership losses passed through may be subject to restrictions imposed under the passive activity loss rules. I.R.C. § 469. These rules, if applicable, could delay the use of the losses until income has been realized in the activity or in the partner's other passive activities, or until the partner has disposed of his interest in the activity or the partnership has disposed of the activity itself. I.R.C. § 469(d), (g).

Although each of the limiting sets of rules catalogued above potentially imposes significant restrictions on the unfettered use of losses allocated to a partner, they should not obscure the general rule itself that partnership losses allocated to a partner pass through to that partner to offset that partner's other income.

<sup>17</sup>See I.R.C. § 172. In contrast to C corporations, S corporation losses are passed through to shareholders under section 1366. I.R.C. § 1366.

<sup>18</sup>I.R.C. § 382.

<sup>19</sup>See BITTKER & EUSTICE, *supra* note 1, ¶ 14.43, 14.44. Changes of a 5% shareholder's ownership resulting in an increase of more than 50 percentage points will trigger a section 382(a) loss limitation if the change also occurs within the three-year period of section 382(i). *Id.* at ¶ 14.43[5]. Under section 382(b), deductions for net operating loss carryovers and built-in losses that the corporation had before the change in ownership are limited to an amount calculated under section 382(b)(1). *Id.* at ¶ 14.43[1]. Any excess losses are carried forward to the next year. *Id.* at ¶ 14.44[1][b].

An S corporation passes through its losses to its shareholders, who can deduct those losses subject to basis limitations.<sup>20</sup> Thus, an S corporation shareholder can deduct losses up to her basis in her shares of the corporation and her basis in loans made by her to the corporation.<sup>21</sup> An S corporation's shareholder obtains outside basis in her shares, however, only for contributions made by the shareholder to the corporation and not for the corporation's liabilities to third party creditors.<sup>22</sup>

Because of the requirements of S corporation qualification, all shares of an S corporation must carry identical financial benefits. As a result, special allocations of tax attributes available to partnerships are not available to S corporations.<sup>23</sup> Moreover, upon a shareholder's sale of S corporation stock, no special inside basis adjustment is available to the S corporation, as it is under the partnership form.<sup>24</sup> Thus, pass-through of losses to an S corporation's shareholders is likely to be more restricted than in the case of a partnership.

For an owner of an equity interest in the business enterprise, choosing the partnership structure over the corporate form can result in substantial current tax savings. The pass-through of losses to partners should make the partnership/LLC form attractive to U.S. domestic angel (early stage) investors, particularly individuals and closely held entities. From a financial reporting standpoint, however, it may involve a disadvantage for many venture capital investors and venture capital investment funds which would prefer not to show losses for financial reporting purposes.

### III. FREQUENTLY STATED REASONS TO USE CORPORATE FORM FOR VENTURE CAPITAL START-UP: THE MYTHS

As set forth in Part II, comparison of the partnership/LLC and corporate forms generally would lead one to choose the partnership/LLC form at the early stages of a business. At a later time, when one of the home run exit strategies comes within reach, conversion to a corporation could be desirable and indeed

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<sup>20</sup>I.R.C. § 1366.

<sup>21</sup>I.R.C. § 1366(d)(1)(B). The at-risk rules of section 465 and the passive loss rules of section 469 apply as well. I.R.C. § 1371(a).

<sup>22</sup>I.R.C. § 1366(d). This is true even if the shareholder guarantees the liabilities of the corporation. I.R.C. § 1366(d)(1). See *Harris v. United States*, 902 F.2d 439 (5th Cir. 1990); *Estate of Leavitt v. Commissioner*, 875 F.2d 420 (4th Cir. 1989), *cert. denied*, 493 U.S. 958 (1989); *Brown v. Commissioner*, 706 F.2d 755 (6th Cir. 1983); *Raynor v. Commissioner*, 50 T.C. 762 (1968); *Perry v. Commissioner*, 47 T.C. 159 (1966), *aff'd*, 392 F.2d 458 (8th Cir. 1968); *Estate of Bean v. Commissioner*, 268 F.3d 553 (8th Cir. 2001) (denying S corporation shareholders who guaranteed corporate debts any increase to their outside bases, resulting in disallowance of NOL deductions); Sumner E. Copple III, *S Corporation Shareholders and Entity-Level Indebtedness: Is a Shareholder Ever Allowed to Deduct Losses Against Entity-Level Indebtedness?*, 10 Akron Tax J. 1 (1993); Danny P. Hall, Jr., *Harris v. United States: Will Loan Guarantees Provide an Increase in Subchapter S Shareholder Basis*, 62 Miss. L.J. 149 (1992). But see *Selfe v. United States*, 778 F.2d 769 (1985). There is no S corporation counterpart to section 752 applicable to partnerships.

<sup>23</sup>There is no S corporation counterpart to section 704(b) applicable to partnerships.

<sup>24</sup>There is no S corporation counterpart to sections 754, 734(b), 743(b), or 755 applicable to partnerships.

could be accomplished at that point.

Nevertheless, planners have frequently advised, and entrepreneurs have frequently chosen, to commence their enterprises as corporations rather than as LLCs. There are several reasons generally given for this choice of entity. The material that follows examines those often-stated reasons for incorporation at commencement of the enterprise.

A. *"To Go Public or Merge with a Public Corporation, You Must Eventually Convert to a Corporation. Might As Well Start There and Avoid the Potential Tax Problems and Expenses of Later Incorporation."*

The argument proceeds that the optimal exit strategies, the home run strategies of going public or engaging in a merger, require the use of the corporate structure. Accordingly, because the business entity needs to adopt the corporate form eventually, it might as well incorporate at the start. An alternate form of this argument is that a start-up business needs to incorporate to attract venture capital funding because incorporating demonstrates that the entity is serious about quickly achieving one of the home run exit strategies.

The tax advantage of incorporation lies largely in the ability of the shareholders of a corporation to achieve greater liquidity and risk diversification in their investment without incurring immediate tax. These objectives can be achieved by either exit strategy: (1) becoming a public company, a status available only to entities treated as corporations for tax purposes,<sup>25</sup> or (2) being acquired in a tax-free reorganization, also a type of transaction reserved for corporations under the tax law.<sup>26</sup>

1. *Going public*

Developing a public market for a corporation's shares is easily accomplished from a tax point of view;<sup>27</sup> a corporation becomes a public company by issuing shares in an initial public offering for cash. Thereafter, sales by the founder shareholders of a portion of their stock, within the limits allowed under the securities law, permits the founder shareholders to diversify their investment by incurring gain and paying tax only with respect to the shares that are sold. Beginning the business under a corporate structure facilitates this process because the entity that will be public is already in existence.

Beginning the business's operational existence as a partnership or an LLC, however, does not create insurmountable hurdles for the business or its owners. It is a rather simple matter to convert the partnership/LLC to a corporation either before or as a part of the public offering of a newly formed corporation's shares under section 351.<sup>28</sup> An incorporation of an LLC can follow three forms: (1) the

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<sup>25</sup>I.R.C. § 7704.

<sup>26</sup>I.R.C. § 368.

<sup>27</sup>From a financial point of view, of course, going public entails substantial difficulties and expenses.

<sup>28</sup>I.R.C. § 351.

LLC can transfer its assets to the corporation in exchange for stock; (2) the LLC can distribute its assets to its members who then contribute those assets to the corporation in exchange for stock and; (3) the members can contribute their interests to the corporation in exchange for stock. In Revenue Ruling 84-111,<sup>29</sup> the Service ruled that the tax consequences, for example, bases and holding periods, would follow the form chosen.

The incorporation of the LLC can also take place as part of the initial public offering. For example, the LLC's contribution of its property, or the LLC members' contribution of their LLC interests (or property received from the LLC), to a newly created corporation at the same time as the corporation's sale of its own stock to other shareholders for cash will come within the scope of section 351. That is because the transferors as a group will be in "control," as defined in section 368(c),<sup>30</sup> "immediately after the exchange [for stock in the corporation]," as required under section 351(a).<sup>31</sup> In this form of transaction, Regulation section 1.351-1(a)(3) treats a purchase of stock from an underwriter in a public offering as a direct transfer to the corporation, disregarding the underwriter, for purposes of section 351.<sup>32</sup> As such, the transfers will be tax-free to the property contributors to the extent that section 357(c) does not apply to the transaction.<sup>33</sup>

Section 357(c) will apply to an LLC's transfer of its business to a corporation in exchange for stock if the liabilities of the LLC exceed the LLC's basis in its assets.<sup>34</sup> In that event, the LLC will recognize gain to the extent of the excess. Each member's share of the gain, in general, will be equal to the amount of that member's negative tax capital account. Similarly, if the LLC's members exchange their membership interests for stock in the newly formed corporation, any member with a negative tax capital account in the LLC will recognize gain on the exchange to the extent of that negative capital account balance. This is because the member will be considered to recognize the member's allocated share of LLC liabilities as liability relief on the transfer. That share of liabilities is governed by section 357(c) to the extent it exceeds the member's outside basis.<sup>35</sup> In general, a member will have a negative (tax) capital account if the LLC's losses that have passed through to the member exceed that member's net investment (cash plus the basis of property contributed less distributions) in the LLC.

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<sup>29</sup>Rev. Rul. 1984-111, 1984-2 C.B. 88.

<sup>30</sup>I.R.C. § 368(c).

<sup>31</sup>I.R.C. § 351(a).

<sup>32</sup>Reg. § 1.351-1(a)(3).

<sup>33</sup>Section 357(c) provides an exception to the generally tax-free treatment of incorporations under section 351. Under section 357(c), a transfer of property in exchange for stock of a corporation (to which section 351 applies) is treated as receiving boot, generally taxable, to the extent that the liabilities of the transferor that are assumed by the corporation exceed the adjusted basis of the property transferred to the corporation pursuant to the exchange.

<sup>34</sup>I.R.C. § 357(c).

<sup>35</sup>I.R.C. § 357(c).

For example, suppose an LLC was formed by its members, A and B, each contributing \$100,000 to the LLC for an equal interest. The LLC then borrowed \$800,000 (either recourse or non-recourse) and expended the entire \$1,000,000 on deductible expenses, such as research and experimental expenses qualifying under section 174.<sup>36</sup> A and B will each have their distributive share of the \$1,000,000 of the deductions or \$500,000 passed through to them. Each of A and B's outside basis in the LLC will include the amount of cash contributed (\$100,000) and a share of the LLC's liability (\$400,000), and before loss pass-through, will be \$500,000. Losses passed through to the members will reduce their respective outside bases to zero.

From a tax accounting perspective, however, each member will have a beginning tax capital account of \$100,000, and the pass-through losses will reduce each member's tax capital account to a negative \$400,000. This negative capital account reflects the excess of each member's share of losses over her respective cash contributions to the LLC.

A transfer by the LLC of its assets subject to its liability to a newly formed corporation owned equally by A and B will trigger gain to each of A and B under section 357(c) in the amount of \$400,000. That is because each member's share of the excess of the LLC's liability assumed by the corporation (\$800,000) over the LLC's basis in its assets (\$0) will equal \$400,000. As such, the gain recognized by the member is the amount of her negative capital account in the LLC.

Alternatively, A and B may transfer their LLC interests to the corporation in exchange for shares. Under this alternative form of transaction, the excess of each member's share of LLC liability (\$400,000), deemed assumed by the corporation in the transaction over her outside basis (\$0), triggers gain under section 357(c) in the amount of the excess. In this example (which represents the general case but not all cases) the gain will be \$400,000, the amount of the respective members' negative capital accounts.<sup>37</sup>

Nevertheless, a transfer that triggers section 357(c) might entail certain tax benefits that would not have been available had the business started as a corporation. For example, if the members had negative (tax) capital accounts resulting from the pass-through of losses during operations as an LLC, then the contributions of their respective membership interests would result in gain to those members as discussed above. If a contributor owned less than 50% of the corporation after the formation transaction, then the character of his gain would be unaffected by section 1239.<sup>38</sup> Thus, if an LLC member contributed his LLC interest to the corporation under these circumstances, his section 357(c) gain

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<sup>36</sup>I.R.C. § 174.

<sup>37</sup>It should be noted that if the aggregate of the members' outside bases does not equal the LLC's inside bases in its assets, then the members' negative capital accounts may not be equal to the gain to be recognized under the alternative form of the transaction. *See* Rev. Rul. 1984-111, 1984-2 C.B. 88.

<sup>38</sup>Section 1239, in general, transforms the gain realized by a transferor to a controlled corporation (50% or greater than 50% ownership) to ordinary income under some circumstances.

would likely be capital gain. Moreover, if that contributor had passive ordinary losses from the LLC carried over from previous years, those losses would be freed up, resulting in advantageous capital gain and ordinary loss, both triggered by the incorporation.

## 2. Tax-Free Reorganization

The other sought-after exit strategy is the acquisition of the corporation by a public company whose shares are readily saleable because they have a public market. The acquisition would be tax free to the corporation and to its shareholders because it would satisfy the requirements of one of the paragraphs of section 368(a).<sup>39</sup> For ease of reference and discussion, the discussion below refers to this type of a transaction as a merger, generally the easiest of the subsections under which to qualify. In reality, however, it could take one of several different forms described in section 368.<sup>40</sup>

In the merger, the shareholders of the merged corporation, sometimes referred to as the target, receive their acquiring company shares tax free.<sup>41</sup> But those shareholders take a basis in the shares they receive equal to the basis they had in the target company's shares.<sup>42</sup> In that sense, the tax on the disposition is deferred until sale or other taxable disposition of those shares. Those shares, presumably, can now be sold piecemeal, so that the target company's shareholders will have achieved liquidity and the opportunity to diversify their investment. Moreover, in the event the target company's shareholders receive some cash (but not so much cash as to disqualify the transaction from reorganization treatment), the shareholders will recognize gain (or sometimes dividend income) to the extent of the cash received.<sup>43</sup>

In contrast, the acquisition by an acquiring corporation of the assets of an LLC or of all of the members' interests in the LLC for stock may or may not be tax free to the members, depending upon whether, immediately after the transaction, the target LLC or its members control (own at least 80% of the stock of) the acquiring corporation.<sup>44</sup> If they do, the transaction will qualify under section 351 for the LLC or the members, as the case may be, as transferors. Such control by the target LLC or its members would be unusual indeed, so that in general, the LLC transaction will constitute a taxable exchange for the members.

a. *Incorporation of LLC Prior to Merger or Other Reorganization.* Suppose, however, that the LLC first converted to a corporation under section 351,<sup>45</sup> as discussed above, and then engaged in the merger. If the two transactions were

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<sup>39</sup>See I.R.C. § 368(a)(1).

<sup>40</sup>See I.R.C. § 368(a)(1).

<sup>41</sup>I.R.C. § 354.

<sup>42</sup>I.R.C. § 358.

<sup>43</sup>I.R.C. § 356. The basis of the shares received will be determined under section 358, taking into account the cash received and the gain or dividend income recognized.

<sup>44</sup>See I.R.C. § 368(c).

<sup>45</sup>I.R.C. § 351.



treated as separate and independent, the benefits associated with the reorganization would be achieved because there is no express requirement in section 351 that the transferor maintain continual control of the transferee corporation. If the transfer and reorganization steps are combined under a step transaction or related theory, however, the transactions could be viewed as a transfer of assets by the LLC to the acquiring corporation in exchange for stock in the corporation, in effect ignoring the incorporation transaction. As a result, the entire transaction would be a taxable exchange.

*West Coast Marketing Corp. v. Commissioner*<sup>46</sup> involved a taxpayer who owned an undivided partial interest in land. The taxpayer and another joint owner of the land simultaneously transferred their interests in the land to a corporation ("M Corp") in exchange for stock. That exchange, purported to be tax-free under section 351, was followed with an exchange of the shares received in M Corp for shares in a public company, purported to qualify as a B reorganization. The Tax Court found this latter exchange to be imminent at the time of the incorporation.<sup>47</sup> Following the exchange, the public company liquidated its newly acquired M Corp subsidiary. The Tax Court, relying on *Gregory v. Helvering*,<sup>48</sup> held that M Corp was not organized or used for any business purpose and the exchange with the public company did not constitute a reorganization.<sup>49</sup> Rather, the transaction was, in substance, a taxable exchange of land for public company stock.<sup>50</sup>

Similarly, in Revenue Ruling 70-140,<sup>51</sup> the Service disallowed section 351 treatment for the transfer of assets by a sole proprietorship to a controlled corporation (which already owned a business) followed immediately by the exchange of the stock in the controlled corporation for stock of the acquiring corporation. The Service reasoned that the transferor of the sole proprietorship was not in control of the transferee corporation because the two steps, the transfer of assets and the exchange of shares, were integrated, and the test of control must be applied with regard to the acquiring corporation.<sup>52</sup> In the ruling, the Service recast the integrated transaction as the taxpayer's transfer of assets to the acquiring corporation, followed by a subsequent transfer of those assets to the acquiring corporation's newly created subsidiary.<sup>53</sup>

Potential challenges to a transaction that satisfy the technical statutory requirements of tax-favored status under sections 351 and 368 come under several judicial doctrines known as "business purpose," "substance over form," "sham,"

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<sup>46</sup>46 T.C. 32 (1966).

<sup>47</sup>*Id.* at 41.

<sup>48</sup>293 U.S. 465 (1935) (disallowing reorganization treatment where the transfer of assets lacked a business purpose).

<sup>49</sup>*West Coast Marketing Corp.*, 46 T.C. at 41.

<sup>50</sup>*Id.* at 40-41.

<sup>51</sup>Rev. Rul. 1970-140, 1970-1 C.B. 73.

<sup>52</sup>*Id.*

<sup>53</sup>*Id.*

and “step transaction.”<sup>54</sup> Each of these doctrines, when invoked against a taxpayer, involve (1) tax avoidance, (2) suspect or undeterminable business benefit<sup>55</sup> from the transaction when viewed apart from tax avoidance, and, frequently, (3) preliminary or subsequent transactions that are related to the transaction or transactions for which tax advantageous treatment is sought. These doctrines are generally viewed as taking their roots from *Gregory v. Helvering*.<sup>56</sup> All of these doctrines seek to elevate economic reality over the artificial form selected to navigate the transaction through the technical requirements of the statute.<sup>57</sup>

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<sup>54</sup>The step transaction corner of these doctrines has been further analyzed according to the test to be applied to determine when steps in an integrated series of steps should be combined in arriving at the tax consequences of the transaction or transactions. For example, the “binding commitment” test would link the transactions if at the time of the first step, the party or parties at issue were legally bound to the follow-up step(s). The “interdependence test” requires that the steps be so interrelated that the initial step(s) would not have been undertaken without expectation, albeit not a legally binding commitment, that the follow-up step(s) would be completed. The “end result” test amalgamates the steps if it appears that they were each really parts of a single transaction intended at the outset. See generally BITTKER & EUSTICE, *supra* note 1, ¶ 12.6[3]. While tax scholars like to slice, dice and categorize, courts frequently invoke the step transaction doctrine without specifying the test employed in their search for the true substance of the transaction. See, e.g., *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

<sup>55</sup>In *West Coast Marketing Corp.*, the court found taxpayer’s purported business purpose “slippery and unconvincing.” 46 T.C. 32, 40 (1966).

<sup>56</sup>293 U.S. 465 (1935).

<sup>57</sup>In contrast, taxpayers are often stuck with the form they chose. See *Turner Broadcasting Sys. v. Commissioner*, 111 T.C. 315 (1998) (refusing to apply step transaction, finding the form chosen by the taxpayers controlling); *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), *aff’d without published opinion*, 886 F.2d 1318 (7th Cir. 1989) (finding the form controlling because the taxpayers took no unnecessary steps when conducting a tender offer and redemption); BITTKER & EUSTICE, *supra* note 1, ¶ 1.05[2][b].

Even this proposition admits to notable exceptions. Traditionally, the Service has permitted taxpayer deviation from form where the intended path is clear, the statute was intended to cover the transaction, but certain non-tax obstacles stand in the way of using a technically conforming format for the transaction. See, e.g., Rev. Rul. 1983-142, 1983-2 C.B. 68 (applying a step transaction approach for the benefit of a taxpayer in order to permit qualification of a transaction under section 355, where transitory steps involving a sale of the stock of the controlled corporation to its parent for cash and a subsequent distribution of that cash to the parent as a dividend were taken for the purpose of complying with local law of the foreign jurisdiction in which the controlled corporation was incorporated); see also Rev. Rul. 1978-397, 1978-2 C.B. 150 (permitting deviation from form where the deviation was necessary to comply with state capitalization requirements); P.L.R. 1995-10-070 (Mar. 10, 1995) (treating an exchange offer made after the reorganization pursuant to a settlement agreement as part of the reorganization); P.L.R. 1992-32-022 (Aug. 7, 1992) (permitting a stepped-up basis for both phases of a partnership purchase because the two steps were necessary for “non-tax reasons”). Furthermore, in *King Enterprises, Inc.*, 418 F.2d 511 (Ct. Cl. 1969), the court linked a share purchase and a merger to find a single tax-free merger. See also Martin D. Ginsburg & Jack S. Levin, *Integrated Corporate Acquisitions: Comments on Rev. Rul. 2001-46*, 93 TAX NOTES 553 (Oct. 22, 2001) (critiquing Revenue Ruling 2001-46, 2001-42 I.R.B. 1, which stepped together a qualified stock purchase and an upstream merger of T into P in the midst of a section 338(h)(10) election to find a valid section 368(a)(1)(A) reorganization).

A similar result as in *King Enterprises, Inc.*, but at the behest of the Service, was reached in *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995) (purchase of majority of target corporation stock by acquiring corporation for stock or cash followed by merger of target corporation into subsidiary of acquiring corporation, with remaining shareholders of target corporation receiving stock of acquiring (parent) corporation, held a reorganization under section 368(a)(2)(D), consistent with the Service’s position in that case, causing target corporation shareholders’ losses to be denied).

It would appear, however, that a potential step transaction attack on the intended benefits of the separate incorporation followed by reorganization should be overcome as long as, at the time of the incorporation, there was no legally binding or practical agreement on the reorganization transaction. Caution would suggest that the incorporation be completed before reorganization negotiations are even entered into, so that at the time of incorporation, a future merger, asset acquisition, or stock acquisition is only an abstract possibility. As a matter of law, however, the separate incorporation may very well be respected even if some negotiations had already commenced at the time of the incorporation. The degree to which there has been a meeting of the minds on the ultimate terms of the acquisition will likely be the most important factor. The time interval between the incorporation and the acquisition will be important as well because the greater the interval, the less likely the acquisition will be assured of ever taking place. The independent business purpose of the decision to incorporate, apart from the hoped for acquisition at hand, will be an important factor as well. The existence of other corporate suitors with whom no negotiations had yet commenced or the prospects of a public offering could substantiate the business purpose of the incorporation. Needless to say, the application of step transaction to this type of transaction is a gray area.

Some practitioners warn that there is rarely enough time to separate the steps sufficiently for comfort, but this issue is really only one of sufficient planning ahead. Indeed, the cautious advisor could recommend incorporation once the business reached sufficient size or profitability to be an attractive acquisition candidate. Admittedly, in that case an incorporation decision would have to be faced with no assurance that a reorganization or public offering would follow. Subsequent liquidation of the corporation with high value, low basis assets could be costly if the exit scenario never develops because there would be no corporate net operating loss carryover to shield the corporate level gain on liquidation. As a result, choosing the right time to incorporate will be something of a balancing act and require careful judgment, knowledge of the market, and perhaps a willingness to take some tax risk. These tax risks can be minimized with appropriate foresight, however, and should not constitute a serious impediment to operating the business as an LLC until an incorporation decision becomes appropriate.

Under some circumstances, an incorporation coupled with an S corporation election could be an effective hedge against double taxation. This plan, however, may be of limited use in more complicated capital structures because of the restrictive requirements for S corporation qualification.<sup>58</sup>

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More recently, in Revenue Ruling 2001-26, 2001-23 I.R.B. 1297, the Service stepped together under the most lenient, "end result" test, an acquisition under a tender offer of 51% of the stock of the target corporation for stock of the acquiring parent corporation, followed by the merger of a transitory subsidiary of the parent into the target for stock of the parent and cash, treating the entire transaction as a reverse triangular merger under section 368(a)(2)(E).

<sup>58</sup>E.g., one class of stock, no corporate shareholders. See I.R.C. § 1361(b).

Thus, the incorporation phase of the life cycle of a putative public company or tax-free acquisition target need not begin at the inception of the business. Incorporation can be accomplished before or as part of a public offering or in advance of acquisition discussions with a potential acquiring corporation. The extra expense involved in forming an LLC is minimal for an enterprise that will be going public or the target of a lucrative merger offer. If neither opportunity develops, however, then the costs of incorporation will be saved, which will offset the costs of formation of an LLC, and in the interim, the tax advantages of LLC treatment will be enjoyed—a benefit that may very well be substantial.

b. *Incorporation at inception without achieving exit strategies.* If, on the other hand, incorporation at the inception of the business is chosen and neither home run exit strategy becomes viable and the start-up business must be disposed of in some other way, incorporation will result in substantial and expensive tax disadvantages. These disadvantages can be examined under several possible scenarios.

Suppose A and B had formed a business entity (partnership/LLC or C corporation) by each contributing \$100,000 cash. During the years of operation, the business entity spent the cash on deductible expenses, in part, to develop software and in part to grow the business. During those years of operations, revenues and costs, other than the foregoing \$200,000, were equal. The parties, A and B, have now decided to sell the business for cash in a taxable sale, either assets or ownership interests. At the time of sale, the entity owns the developed software worth \$2,000,000 and goodwill worth \$1,000,000, as set forth in the table below.

	Adjusted Basis	Fair Market Value
Software	\$0	\$2M
Goodwill	\$0	\$1M

The cash sale can take place in three ways, each of which is analyzed below, comparing partnership results with corporate results. The disadvantages of incorporation follow from the situation that the C corporate structure will entail a corporate level tax in addition to a shareholder level tax. The analysis below illustrates the ramifications of this observation in different situations.

(1) *Sale of Assets.* Assume that the business itself, that is, the entity's assets, is sold for \$3,000,000.

If the entity were a partnership, the partnership would realize and recognize gain in the amount of \$3,000,000 but would not itself be subject to tax on that amount. Rather, the gain would pass through to the partners, A and B, who would each be subject to tax on their respective share of the gain. Assuming that the partnership's assets have been held long term, the aggregate tax to the partners at the long-term capital gain rate of 20% would be \$600,000. This same treatment would result if the selling entity were an S corporation. Note also that in both situations, the partners or S corporation shareholders would have previ-

ously deducted their respective shares of the entity's \$200,000 of deductible expenses.

If the selling entity were a C corporation, on the other hand, it would realize gain in the amount of \$3,000,000, which could be offset, in part, by the corporation's net operating loss carryover in the amount of \$200,000 (software development costs and other previously deducted items), resulting in net gain at the corporate level of \$2,800,000, which would be taxed at the rate of 34%. The net corporate level tax would be \$952,000. Further, upon distribution of the after-tax proceeds of the sale in the aggregate amount of \$2,048,000 to A and B, those shareholders, if individuals, would also be subject to tax on their gain (presumably preferentially taxed at the long-term capital gain rate of 20%) for an aggregate shareholder level tax of 20% on \$1,848,000 gain or \$369,600. The total combined tax would be \$1,321,600. This amount is substantially greater than the tax resulting from the partnership's sale of assets.

If the corporation is a qualifying corporation under section 1202,<sup>59</sup> however, the gain on the sale of the stock could qualify for the special low capital gain rates provided in the section. Qualification requires, among other things, a high-tech business and a longer holding period than is generally required for long-term capital gain treatment.<sup>60</sup> There is no partnership counterpart to section 1202.

(2) *Liquidation, followed by sale of assets.* The consequences in both the partnership and corporate contexts will be the same as described in Scenario (1). In the corporate context, it is immaterial whether there is a sale of assets first and then a liquidation or simply a liquidation, because in both cases, the corporate level gain and shareholder level gain will be as determined in Scenario (1), as if the corporation sold its assets to its shareholders for their fair market value and then distributed its sales proceeds in liquidation.

The partnership situation is somewhat more complex, in that a liquidation followed by a sale of assets by the partners will generally yield the same result

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<sup>59</sup>I.R.C. § 1202.

<sup>60</sup>I.R.C. § 1202. Section 1202 provides a tax benefit for the sale or exchange of "qualified small-business stock." A "qualified small business" is a domestic C corporation whose "aggregate gross assets" do not exceed \$50,000,000 either before or immediately after the stock issuance. See I.R.C. § 1202(d)(1), (2). The corporation must also meet the active business requirement of section 1202(c)(2) for "substantially all" the time the stock is held in order for the stock to qualify. I.R.C. § 1202(c)(2)(A). The active business requirement, as defined in section 1202(e), states that at least 80% of the corporation's assets must be used in the "active conduct of one or more qualified trades or businesses." I.R.C. § 1202(e)(1)(A). Corporations engaged in servicing, banking, leasing, or farming are not qualified. For a complete list of excluded businesses, see section §1202(e)(3).

For the stock to qualify, it must be original issue stock, and the taxpayer must not have acquired it in exchange for stock or for underwriting services. I.R.C. § 1202(c)(1). If the required holding period of more than five years is satisfied and all other requirements are met, the taxpayer may exclude 50% of the gain from income, subject to the limitations set forth in section 1202(b). I.R.C. § 1202(a). Furthermore, a 60% exclusion is available for qualified small-business stock of a "qualified business entity" held more than five years if the stock was acquired after December 21, 2000. I.R.C. § 1202(a)(2)(A). For the "qualified business entity" requirements, see section 1397C(b).

as a sale followed by liquidation.<sup>61</sup> However, the liquidation of a partnership that is not followed by the partners' sale of the assets they receive, in general, will be tax free to the partnership and the partners.<sup>62</sup>

For an S corporation, a liquidation followed by a sale of assets, like a partnership, generates only one level of tax. But a liquidation that is not followed by a sale, unlike a partnership, generates immediate gain at the S corporation level, passed through to the shareholders, on which tax is due at that time. There is a basis step-up to the shareholders to avoid a second layer of tax on the same gain, but the timing may be very disadvantageous to the shareholders as compared to partners of a partnership, who defer gain until sale of the assets.

(3) *Sale of Stock or Partnership Interests.* The sale of partnership interests will generate a partner level gain, generally taxable as capital gain, although dependent on the type of assets in the partnership.<sup>63</sup> In general, the consequences will be roughly the same for the sellers as if the partnership sold its assets and liquidated.

The purchaser of a partnership interest will be able to capture the tax benefits of the full amount paid for the partnership interest, if the partnership makes an election under section 754.<sup>64</sup> In that event, section 743(b) and the regulations thereunder provide for an adjustment in the partnership's basis in its properties with respect to the purchasing partner—a "special inside basis adjustment."<sup>65</sup> The net impact of the adjustment is to defer gain at the partnership level that would pass through to the purchasing partner upon the sale or other disposition of partnership properties and in some cases allow additional depreciation for that partner, roughly as if the partner had purchased an undivided share of the properties themselves.

In the corporate context, assuming no section 338 election,<sup>66</sup> only one level of tax will be incurred—the capital gain tax at the shareholder level. Nevertheless, the built-in appreciation in corporate assets, sometimes referred to as "built-in-gain," will remain in the corporation, the ultimate tax consequences from which

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<sup>61</sup>Rev. Rul. 1984-111, 1984-2 C.B. 88; *see McCauslen v. Commissioner*, 45 T.C. 588 (1966) (refusing to permit tacking of the partnership's holding period to assets that the partner acquired when a two person partnership terminated due to that partner's purchase of the other partner's interest, because whereas the selling partner sold a partnership interest, the purchasing partner was deemed to have bought an undivided interest in the partnership's assets); Rev. Rul. 1999-6, 1999-1 C.B. 432 (ruling, in part, that when a non-member taxpayer purchases all the interests in an LLC, causing termination of the LLC's partnership status, the purchaser is deemed to have purchased the assets of the LLC following a deemed distribution to the selling members).

<sup>62</sup>Note that a shift in liabilities could cause taxation to some partners, and section 751(b) could accelerate income to some partners if the liquidation involved "unrealized receivables" or "inventory" which has "appreciated substantially in value" (defined in sections 751(c), (d) and (b)(3)(A), respectively) and was not pro rata with respect to these hot assets.

<sup>63</sup>A portion of the selling partner's gain may be characterized as ordinary income under section 751, however, if the subject partnership owns hot assets, which for purposes of section 751(a) include unrealized receivables (section 751(c)) and all inventory (section 751(d)).

<sup>64</sup>I.R.C. § 754.

<sup>65</sup>I.R.C. § 743(b); Reg. § 1.743-1.

<sup>66</sup>I.R.C. § 338.

(eventual taxable gain, reduced deductible loss, or reduced depreciation) will be borne by the purchaser. Presumably, the purchaser will insist upon a downward price adjustment to reflect the existence of the corporation's built-in gain. Thus, the corporate level tax on appreciation in corporate assets can be delayed but cannot be avoided, because at the very least, it should reduce the amount the buyer would be willing to pay for the stock.

For an S corporation, an election can be made by the corporation under section 338(h)(10) to treat the stock sale as an asset sale.<sup>67</sup> Absent such an election, however, the sale of stock at a gain could result in the purchaser suffering the corporate level detriment described above with respect to C corporations if the S corporation ceases to qualify as such after the sale. Even if it continues to qualify, a sale of stock will involve timing disadvantages for the new shareholders if the corporation's properties are later sold. There is no S corporation counterpart to the special inside basis adjustment applicable to partnerships under sections 754 and 743(b).<sup>68</sup>

As the three scenarios demonstrate, if the exit strategy involves a taxable sale, the partnership structure is likely to be less expensive from a tax perspective than the corporate structure. More importantly, the parties can get themselves out of a partnership or LLC structure often without tax and always without entity level tax. This is not so with a corporation. Finally, if it becomes desirable for a business begun as a partnership to be a corporation, either to raise money or in order to participate in a tax-free acquisition with another corporation, then a conversion to a corporation can generally be accomplished without incurring tax.<sup>69</sup> The reverse is not true. One cannot convert a corporation into an LLC tax-free.<sup>70</sup>

#### B. "We Need Stock and Options to Compensate Our New Employees."

Stock options, whether nonqualified or qualified incentive stock options (ISOs), have been a useful tool in attracting talented employees to work for cash-poor but prospect-rich high-tech and not so high-tech Internet start-up companies. Being able to offer a software developer 10,000 stock options, allowing the employee to share in the good fortune of the company when the home run scenario occurs, can be important to a cash-strapped start-up.<sup>71</sup>

Corporate stock options are well understood by both the grantor corporations that issue them and the grantees. They can take the form of either non-qualified

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<sup>67</sup>I.R.C. § 338(h)(10).

<sup>68</sup>I.R.C. §§ 754, 743(b).

<sup>69</sup>See *supra* Part III.A.2.a.

<sup>70</sup>See James A. Fellows & Michael A. Yuhas, *Converting to a Limited Liability Company: The Issue of Debt Allocation to the LLC Members*, 79 TAXES 23 (Oct. 2001) (discussing the tax consequences of converting C corporations and S corporations to LLCs).

<sup>71</sup>Never mind that there are 10,000,000 shares of stock of the start-up issued and outstanding and the company has no hard assets to speak of. 10,000 shares at a typical public offering price of \$10.00 per share will generate \$100,000 in stock value, a tidy sum for a new economy worker just out of college. Further, even a mere college graduate can be made to understand the meaning of a corporation and a stock option to purchase that corporation's stock at what appears to be a very low price.

options (sometimes called non-statutory options) or ISOs. If the options are non-statutory or nonqualified options, then in general, the recipient does not realize income when he receives them.<sup>72</sup> Rather, income is realized when the options are exercised by the recipient and the measure of that income is the so-called spread—the difference between the exercise price and value of the stock at the time of exercise.<sup>73</sup> At that time, however, the corporation will be entitled to deduct that same amount in computing its taxable income.<sup>74</sup>

On the other hand, if the options are statutory or ISOs, then no income is realized by the service provider either upon receipt or exercise of the option for regular tax purposes.<sup>75</sup> (The spread at exercise is considered a tax preference for purposes of the alternative minimum tax (AMT), however, and included in the computation of alternative minimum taxable income for AMT purposes.<sup>76</sup>) Further, gain on sale of the stock received upon exercise of an ISO is eligible for long-term capital gain rates if the stock is held for the requisite long-term holding period.<sup>77</sup> No deduction, however, is allowed to the corporation upon exercise of the ISO or upon sale by the option holder of the stock.<sup>78</sup> To qualify as an ISO, certain statutory requirements must be satisfied, including the requirements that the strike price must be at the fair market value of the stock determined at the time of grant and the employee must actually pay for the shares at exercise.<sup>79</sup>

One could fashion a similar plan creating options (nonqualified only) to purchase partnership/LLC interests.<sup>80</sup> The exercise of the option, as in the case of a corporation, will result in income to the option holder in the amount of the spread (the excess of the value of the partnership interest over the option exercise price) and a deduction to the partnership (if the option was granted for past services for which cash compensation would have been regarded as ordinary under section 162<sup>81</sup>). In addition, there is a substantial body of authority that holds that the exercise of an option will result in other tax consequences to the LLC, resulting from what has come to be known as a “capital shift.” Under a theory espoused by leading commentators,<sup>82</sup> the LLC would be deemed to have transferred, at each option exercise, an undivided portion of each of its assets in

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<sup>72</sup>See Regulation section 1.83-7 which provides for non-inclusion treatment if the option does not have a readily ascertainable fair market value at the time of the grant, which is the usual situation for employee stock options.

<sup>73</sup>See *id.*

<sup>74</sup>Reg. § 1.83-6.

<sup>75</sup>I.R.C. § 422.

<sup>76</sup>I.R.C. § 56(b)(3).

<sup>77</sup>I.R.C. § 1222(3).

<sup>78</sup>I.R.C. § 421(a)(2).

<sup>79</sup>I.R.C. § 422(b).

<sup>80</sup>See W. Welke & O. Loy, *Compensating the Service Partner with Partnership Equity: Code Sec. 83 and Other Issues*, 79 TAXES 94 (Mar. 2001).

<sup>81</sup>I.R.C. § 162.

<sup>82</sup>See WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 4.01[8] (2001); ARTHUR B. WILLIS ET AL., *PARTNERSHIP TAXATION* ¶ 4.05 (2001). The theory is apparently based on the concept that a partnership is essentially an aggregation of its partners, with certain entity features statutorily superimposed.



the proportion that the value received as compensation by the option holder bears to the value of the entire LLC (with a concomitant basis step-up in those assets equal to the gain recognized with respect thereto). However, another leading commentator rejects this analysis,<sup>83</sup> and resolution of the conflict remains uncertain. There is very little case law on the point and the case generally cited deals only with the granting of a capital interest in a partnership at the initial formation of the partnership for services rendered to the other partner prior to the formation, but does not deal with the consequences to a partnership that was already in existence.<sup>84</sup>

If there will be successive grants and, more importantly, option exercises at varying times, the LLC will have to engage in the successive revaluation of its assets and provide special allocations of gain (the event of revaluation upon the entry of subsequent new members) to reflect in each old and new partner's capital account and each old partner's share of unrealized profits from the time of receipt of the partnership interest to the time of the new entrant. This adds substantial complexity to the structure, even if option exercise is limited to once per year, and entails a difficult task of explaining the situation to the new employee and to his advisor, assuming he has one with sufficient sophistication.

Alternatively, in lieu of options, the LLC could grant actual profits interests in the LLC to the service providers (as distinguished from interests in the capital of the LLC). The profits interests could take the form of Class B Member Units with zero beginning capital account balances. As such, the Class B units would have no claim on the assets of the LLC if the LLC were liquidated immediately.

Under this scenario, a new service provider member should have no income as a result of receiving the profits interest. This result stems from the theory that an interest in future profits has only speculative and undeterminable value at the time of receipt and therefore does not constitute income upon receipt.<sup>85</sup> Upon hypothetical liquidation of the LLC at the time of the service provider's receipt of the profits interest, all of the LLC's property would be distributed to the capital contributor members who have capital accounts in the newly formed

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<sup>83</sup>See ALAN GUNN, *PARTNERSHIP INCOME TAXATION* 40 (3d ed. 1999); see also Welke & Loy, *supra* note 80, at 100.

<sup>84</sup>See *McDougal v. Commissioner*, 62 T.C. 720, 728 (1974) (treating the contribution of services for a joint venture interest as a two-step process in which a share in the venture's asset was first transferred to the services venturer who then, with the other venturer, contributed the whole asset to the partnership).

<sup>85</sup>See *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), *rev'g* 59 T.C.M. (CCH) 236, 1990 T.C.M. (RIA) ¶ 90,162 (holding that the receipt of a profits interest in exchange for services was not a taxable event); *St. John v. United States*, 84-1 U.S.T.C. ¶ 9158, 53 A.F.T.R.2d 84-718 (C.D. Ill. 1983) (applying a "liquidation analysis" to find that the profits interest had no value on receipt and therefore did not create taxable income); *Kenroy, Inc. v. Commissioner*, 47 T.C.M. (CCH) 1749, 1984 T.C.M. (RIA) ¶ 84,232 (applying the "liquidation analysis" to find the receipt of a profits interest nontaxable); see also *Hale v. Commissioner*, 24 T.C.M. (CCH) 1497, 1965 T.C.M. (RIA) ¶ 65,274 (stating in dicta that profits interests do not constitute taxable income on receipt); *McKee et al.*, *supra* note 83, ¶ 5.02; *Willis et al.*, *supra* note 83, ¶ 4.06. *But see* *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir. 1974).

LLC equal to the value of their contributions or their restated capital account balances if the LLC's assets have been revalued. The capital contributor members have priority and would receive the first amount of liquidation proceeds up to the amount of their capital account balances in the LLC, which would be equal to the value of the LLC's property at that time, leaving no liquidation proceeds for distribution to holders of a profits interest.

The Service generally accepts this theory and result but limits application to non-abusive situations delineated in Revenue Procedure 93-27.<sup>86</sup> Nevertheless, even if the Revenue Procedure requirements are not satisfied, there is a substantial body of thought and authority supporting tax-free treatment of the transaction. Although granting of a profits interest has different economic consequences than the granting of a capital interest, it generally accomplishes the parties' objectives and has substantially more benign tax consequences.

The following example illustrates this type of arrangement. Suppose A and B desire to form a partnership to which A will contribute appreciated software with a basis of zero and a fair market value of \$200,000. B agrees to provide future services to the partnership and will receive in exchange a profits interest in the partnership of 50%. As long as the requirements of Revenue Procedure 93-27 are satisfied, the Service will concede that neither A nor B will recognize income from the formation transaction. Such an arrangement between the parties can build in a provision for B's forfeiture of his interest under certain circumstances, and, if coupled with B's section 83(b) election<sup>87</sup> (and perhaps even if not),<sup>88</sup> can avoid taxation to B even in the future with regard to his receipt of the

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<sup>86</sup>See Revenue Procedure 1993-27, 1993-2 C.B. 343, which provides that the Service will not treat the granting or receipt of a profits interest as a taxable event for the partner or the partnership unless one of the following situations apply: "(1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) If within two years of receipt, the partner disposes of the profits interest; or (3) If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of section 7704(b) of the Internal Revenue Code." The Revenue Ruling was issued to limit the application of *Diamond*, 492 F.2d 286, which held that the receipt of all such profits interests constituted income to the recipient. In Revenue Procedure 2001-43, 2001-34 I.R.B. 191, the Service extended Revenue Procedure 1993-27 treatment to recipients of a profits interest in a partnership even if the interest is subject to substantial risk of forfeiture and no election is made by the recipient under section 83(b), provided certain qualifications are met. For critiques of Revenue Procedure 2001-43, see Susan Kalinka, *Rev. Proc. 2001-43 and the Transfer of a Nonvested Partnership Profits Interest*, 79 TAXES 11 (Dec. 2001) (noting that despite the language in Revenue Procedure 2001-43 and the questionable state of section 83(b)'s applicability to unvested profits interests, taxpayers should still make section 83(b) elections as a protective measure); Glenn E. Mincey et al., *Rev. Proc. 2001-43, Section 83(b), and Unvested Profits Interests – The Final Facet of Diamond?*, 95 J. TAX'N 205 (Oct. 2001) (reviewing the various issues, including problems related to vesting, that the Service failed to address in Revenue Procedure 2001-43, and concluding that section 83(b) elections should still be made as precautionary matters). *But see* Stephen D.D. Hamilton, *Unvested Profits Interests – Why Section 83(b) Does Not Apply*, 95 J. TAX'N 380 (Dec. 2001) (claiming that a section 83(b) election is not relevant, because the service partner does not receive forfeitable property separate from that partner's actual, ongoing service obligation).

<sup>87</sup>I.R.C. § 83(b).

<sup>88</sup>See Rev. Proc. 2001-43, *supra* note 87.

partnership profits interest (but of course not with regard to his allocable share of profits each year).

Moreover, subsequent profits interests in the LLC can be issued to new employees even after the partnership is up and running, as long as the current value of the LLC at the time of the grant is the value used as the base from which a future profits interest is created and measured. However, if successive additional employees are to receive profits interests upon joining the company, the need for special allocations of unrealized appreciation as appropriate among the various new partners who have entered the LLC at varying times and the complications involving valuing assets would persist.

Another alternative involves phantom partnership interests, presumably profits interests. These would give all new entrants economic rights (rights to additional compensation based upon the success of the business) to be kept track of by spreadsheet and obviate the need for special allocations by the LLC itself. Yet each new employee's entry into the plan would require the company to revalue its properties in order to keep track of its appreciation during the employee's tenure.

Under the alternatives involving actual LLC interests (capital or profits), the LLC interests can be converted to stock tax-free when the LLC converts to a corporation in a section 351 transaction under any of the three alternative paths.<sup>89</sup> The treatment of recipients of phantom LLC interests and options is more problematic. It is possible that an employee's phantom LLC interest would qualify as property within the meaning of section 351 because it is in essence an account receivable from the LLC.<sup>90</sup> If that is the case, the employee could transfer his phantom LLC interest to the corporation in exchange for stock tax-free at the time that the actual members transfer their LLC interests to the corporation under section 351. However, there is a body of authority that would disqualify the phantom interest holder as a transferor of property on the grounds that the receivable of the corporation's predecessor is not property within the meaning of section 351, notwithstanding that the services that gave rise to the receivable were not performed for the corporation itself, or alternatively that the incorporation should be deemed to have resulted in the discharge by the LLC of its debt to the phantom interest holder with stock received in the incorporation.<sup>91</sup>

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<sup>89</sup>See Rev. Rul. 1984-111, 1984-2 C.3.88.

<sup>90</sup>Reg. § 1.351-1(a)(1)(i) (providing that stock issued for services rendered to or for the benefit of the issuing corporation is not regarded as issued for property). By its terms, Regulation section 1.351-1 would appear inapplicable to a receivable derived for services performed for another, the LLC, and not in anticipation of the incorporation. See *James v. Commissioner*, 53 T.C. 63 (1970); see also BITTKER & EUSTICE, *supra* note 1, at ¶ 3.02[2].

<sup>91</sup>See *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *reh'g denied*, 339 F.2d 885 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965); see also BITTKER & EUSTICE, *supra* note 1, at ¶ 3.02[2]. This latter rationale may be at odds with Revenue Ruling 1984-111, which respects the form chosen for an incorporation of a partnership. See discussion, *supra* at Part III.A.1. Presumably, a weaker case is presented for the phantom interest holder if the structure chosen is the transfer by the LLC of its assets rather than the transfer by the members of their LLC interests, even if the phantom interest

The receipt of stock by an LLC option holder would likely be viewed as the transfer of the option and taxable under section 83 and Regulation section 1.83-7(a) as if the option had been exercised and the option holder received value equal to the value of the stock. However, it is possible that section 351 could override the application of section 83 to permit the LLC option, as property, to be exchanged tax-free for stock of the newly formed corporation if all of the requirements of section 351 have been satisfied.

It cannot be gainsaid that partnership/LLC interests are more difficult to understand and their tax treatment is subject to more uncertainty than corporate stock.<sup>92</sup> Moreover, a profits interest in such an entity or a phantom interest, both alternatives to actual options to purchase partnership interests, may very well be regarded suspiciously by the prospective employee. Employees are likely to be predisposed toward stock options, like Microsoft millionaires received. Founders may also be more comfortable with stock and stock options. Even a unitized partnership or LLC, having units instead of bare percentage interests, may prove unsatisfactory to prospective employees. In sum, the corporate structure does carry the advantage of simplicity if ownership options for employees are a significant factor in choosing a structure.

But whether the ability to issue relatively simple options is a significant factor in choosing a structure for a start-up is open to question. Realistically, an option to purchase stock in a nonpublic company is likely to be more illusion than wealth. That is particularly the case if the plan allows the employer to repurchase a departing employee's stock for its fair market value at the time of departure. This type of option provision permits employers to avoid the inconvenience and potential disruption of former employees as current shareholders. Under these circumstances however, the employee does not get the unlimited free ride even on his vested stock, but rather is limited to its appreciation only during his tenure at the company. Because of this feature, the option is tantamount to phantom stock and calling it a stock option without qualification may be misleading. At the least, it should require the same type of explanation incumbent with respect to a phantom partnership interest. But even if the option does not contain this feature, neither it nor the underlying stock is likely to be saleable in the absence of the sale of the entire company, unless and until one of the home run scenarios of public offering or public merger occurs. In that case, why not use an LLC structure with options that are only exercisable upon acquisition of the company or conversion to a corporation and a public offering in connection therewith or a follow-on merger or other tax-free reorganization? This alternative, using an LLC, seems to be an adequate theoretical response to the insistence on incorporation for the principal purpose of facilitating stock

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holder purports to transfer his interest to the corporation as part of the overall transaction. In that case, receipt of the stock by the phantom interest holder could also be viewed as the satisfaction by the transferee corporation with its own stock of the debt assumed from the LLC, resulting in taxable compensation income to the phantom holder.

<sup>92</sup>See Notice 2000-29, 2000-23 I.R.B. 1241, in which the Service indicated that it is considering issuing guidance in this area.

options to attract employees.

Perhaps the foregoing point, while theoretically sound, ignores an important perception—stock options may be a means of attracting young high-tech but financially unsophisticated employees, ready to overvalue the options as compensation and therefore accept less cash compensation than the actual value of the options would warrant. Perhaps this represents a real value of incorporating in the era of irrational exuberance.<sup>93</sup>

### C. “*Venture Capitalists Demand to Invest in Corporations.*”

This third, often-cited reason for choosing the corporate structure has some currency. It is grounded in the fact that venture capitalists are typically investment fund partnerships which invest their constituent partners’ money. The real investors are the partners in the fund and they may be pension funds and other non-tax-paying entities like university endowments or foreign investors.

Tax-exempt investors tend to prefer the corporate form for their investments in order to avoid unrelated business income.<sup>94</sup> Also, foreign investors tend to prefer the corporate form for their U.S. investments in order to avoid being deemed to be engaged in a U.S. trade or business through a permanent establishment, which is generally the situation for foreign partners of a partnership engaged in U.S. business.<sup>95</sup> Such a status for the foreign investor would require U.S. tax filings and possibly tax payments.<sup>96</sup>

#### 1. *Tax-Exempt Investors*

A tax-exempt organization’s distributive share of income from an LLC is treated like income from the LLC’s underlying activities for purposes of the unrelated business income tax (UBIT), as if the income were earned directly by the organization.<sup>97</sup> The tax-exempt organization’s distributive share of the trade or business income of an LLC is characterized as trade or business income of the tax-exempt organization, therefore, and is subject to income tax as unrelated business taxable income under UBIT. As such, it is taxable to those otherwise tax-exempt entities and requires the filing of special income tax returns by them. This treatment is in contrast to dividends, interest, gains from sale of stock and other portfolio (non-business) income, which are tax free to them.<sup>98</sup>

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<sup>93</sup>But financially unsophisticated does not mean dumb, and word gets around that start-up companies without a history of earnings or at least revenue are long shots for the home run scenarios of public offerings and mergers with publicly owned corporations.

<sup>94</sup>See sections 511, 512, and 513, which in general, impose an income tax on otherwise tax-exempt entities on the net income of the entity that is derived from a trade or business that is unrelated to the exempt purpose of the entity, i.e., unrelated business taxable income.

<sup>95</sup>See section 875(1) which provides that “a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged.”

<sup>96</sup>Note that a corporation that has a foreign shareholder is precluded from S corporation qualification. I.R.C. § 1361(b)(1)(B), (C).

<sup>97</sup>I.R.C. § 512(c)(1); Reg. § 1.512(c)-1; see Rev. Rul. 1979-222, 1979 C.B. 236 (applying the rule to both limited and general partners).

<sup>98</sup>I.R.C. § 512(b)(1); see also BITTKER & EUSTICE, *supra* note 1, at ¶ 1.06[8].

Many tax-exempt investors demand that any venture capital fund in which they invest avoids generating income that would subject them to UBIT on the income from the fund and will decline to invest without assurance of this protection. If the fund intends to invest in LLCs, these organizations will not invest in the venture capital fund.

While the reaction described above by tax-exempt entities exists, it tends to be exaggerated. With some advance planning, the tax-exempt entities themselves can overcome the UBIT problems. The UBIT issue only becomes a problem if and when operating income is earned by the portfolio company of the fund.<sup>99</sup> At the point that a portfolio company turns the corner and begins to earn a profit, it can incorporate and avoid the realization of UBIT income for its tax-exempt fund investors.

Choosing the correct point in time for incorporation may be problematic. It may be difficult to predict the exact period of turn-around, so that this solution may not be sufficiently dependable. Moreover, liabilities incurred by the investment fund partnership or, more importantly, any of its portfolio LLCs, may inadvertently result in unrelated debt-financed income consequences to the tax-exempt investor.<sup>100</sup>

A dependable method for avoiding UBIT problems resulting from the venture capital fund partnership investing in LLCs is the creation for the venture capital fund of a corporate entity as one of its partners. UBIT-shy investors can invest in the corporation, which in turn will invest those funds in the venture capital fund partnership. Operating income earned by a portfolio company would pass through to the investor corporation, incur a tax at that level (in lieu of UBIT at the tax-exempt entity's level) and be passed through again to the tax-exempt entity, less income tax paid by the corporation, as dividend income, which is not subject to UBIT.<sup>101</sup> Alternatively, the tax-exempt entity can create a corporation itself to invest in the venture capital fund or several such funds.

Economically, this plan is roughly comparable to the tax-exempt entity paying the tax on the UBIT income, but without having to keep track of that income itself or file the special forms required by the UBIT regime. It should be noted that neither the tax-exempt entity nor the special purpose investment corporation can use the pass-through of a portfolio LLC's losses unless they have first realized income from that company or from other sources. The corollary should also be noted; the use of the LLC structure by start-up businesses to pass through losses causes start-up investments to be tax-preferred. As such, the LLC form for portfolio companies gives taxable investors an advantage over nontaxable investors, who generally enjoy an advantage with respect to taxable investments. In effect, taxable investors are subsidized by virtue of a portfolio company's choice of the LLC structure.

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<sup>99</sup>The tax-exempt organization takes into account both its share of gross income and its share of deductions attributable thereto. Reg. § 1.512(c)-1. (One might quip that generally leaves out from concern investments in Internet companies.)

<sup>100</sup>I.R.C. § 514.

<sup>101</sup>I.R.C. § 512(b)(1); Reg. § 1.512(c)-1.

The situation is somewhat different if the only income ever earned with respect to the portfolio company in corporate form is from the venture capital fund's sale of the portfolio company's stock. In that event, using the special purpose investment corporation as the tax-exempt entity's investment vehicle in the venture capital fund partnership results in a tax on the special purpose corporation's share of the venture capital fund's capital gain. Interestingly, the tax-exempt entity could avoid tax on the gain altogether if it invested in the fund directly as a partner itself without the intermediary corporation. Perhaps the potential extra tax is the price to be paid for avoidance of the administrative burdens of UBIT.

## *2. Foreign Investors*

In general, foreign investors do not want to be engaged in business in the U.S. because it subjects them to U.S. tax on their U.S. source business income and other income effectively connected with the U.S. business.<sup>102</sup> A foreign investor in a venture capital fund partnership that invests in portfolio companies formed as LLCs is deemed to be engaged in the underlying business of the LLCs.<sup>103</sup> The consequence of this rule is that a foreign partner's distributive share of a partnership's U.S. business income is subject to U.S. tax to the foreign partner as U.S. effectively connected income. Moreover, the Service has ruled that even the foreign partner's sale of his partnership interest will be subject to U.S. tax if the partnership or any of its portfolio LLCs had a U.S. office or other fixed place of business in the U.S.<sup>104</sup>

The solution to the problem, however, is not to restrict the fund's investments to corporations, but rather to have foreign investors invest in the fund through a special purpose foreign or domestic corporation. This will insulate the foreign investor from being deemed to engage in U.S. business.

## *3. Hybrid Structure*

The dilemma of choice of entity generally assumes that the choice between corporation and LLC is an either/or choice. However, one recent, celebrated transaction combined both structures in order to obtain the benefits of both. This hybrid structure has come to be known as the "BarnesandNoble.com structure," after the transaction between media giants Barnes and Noble and Bertelsmann A.G. It combined the operational flexibility of the LLC structure with the exit strategy of the corporate structure by taking advantage of the pass-through nature of the partnership/LLC form and the tax-free exit strategies available under the corporate form.

Under a structure modeled after the actual Barnes and Noble transaction, two corporations that desire to engage in a joint venture each create a single purpose subsidiary corporation, which join together as the only members of an operating

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<sup>102</sup>I.R.C. §§ 871, 872 (applicable to nonresident alien individuals); I.R.C. §§ 881, 882 (applicable to foreign corporations).

<sup>103</sup>I.R.C. § 875(1).

<sup>104</sup>See Rev. Rul. 1991-32, 1991-1 C.B. 107.

LLC, the joint venture vehicle. During the operating period, the LLC, as the operating entity, permits the pass through of tax losses to the joint venturers and when the business becomes profitable, the taxable income to the joint venturers, free of corporate tax. A joint venture in corporate form, in contrast, would generate a separate level of tax on dividend payments (without benefit of the full 100% dividends received deduction) because it would not meet the consolidated return requirement with regard to either joint venturer. In addition, using the LLC as the operating vehicle permits special allocations, tax-free distributions in kind, and other typical partnership tax advantages during operations.

Upon achieving the desired financial position for the business, the exit strategy can be commenced by the two corporate participants through the formation of a new C corporation as the third member and manager of the LLC. This new corporation can ultimately be the vehicle for a public offering and so will be referred to as "P-Co."<sup>105</sup> In the Barnes and Noble transaction, P-Co issued two classes of stock: common stock to the public after the initial formation, and non-traded stock (common or preferred) to the two original venturers with a disproportionately large vote ("high vote stock"). Under that structure, following formation, P-Co issued common shares to the public in a public offering, the proceeds from which it used to purchase equity units in the operating LLC. As such, P-Co served as a conduit owner of LLC units and each of its shares could be matched to an LLC unit. Under this plan, the LLC has only three members and therefore does not fall within the scope of a publicly traded partnership under section 7704,<sup>106</sup> even though there is a public market for P-Co shares. In this manner, the pass-through flexibility and single tax attribute of the LLC are preserved, even though ownership of one of its members is public. As time goes by and more equity interests of P-Co are sold to raise funds for the LLC, the public company member, P-Co, will become the largest equity owner of the LLC.

The ultimate exit strategy for the founding corporate joint venturers would permit them to exchange their LLC membership interests for shares of P-Co either directly or through merger of their respective single purpose subsidiaries (which were the actual LLC members) into P-Co. Each transaction contemplated as the exit strategy needs to be disclosed in the P-Co registration statement pursuant to which shares are issued to the public. If the transfers by the single purpose subsidiaries are done at the time of the public offering, then they should qualify for tax-free treatment under section 351.<sup>107</sup>

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<sup>105</sup>This was the nomenclature used in Robert A. Rizzi, *DOTCOM Exit Strategies: Barnes and Noble Reorganization Issues*, 27 J. CORP. TAX'N 315 (Oct. 2000).

<sup>106</sup>I.R.C. § 7704(b).

<sup>107</sup>See Rev. Rul. 1984-111, 1984-2 C.B. 88. But see *Nonrecognition on Incorporation of Sub Denied for Lack of Non-Tax Business Purpose*, 95 J. TAX'N 313 (Nov. 2001) (summarizing Field Service Advice 2001-25-001 (Jun. 22, 2001) in which the Service used the business purpose test to deny section 351 treatment to a parent and its subsidiary on the transfer of property to a second subsidiary); see also Rizzi, *supra*, at 318 (discussing the possible Service challenge to section 351 qualification based upon a "lack of business purpose" argument); *Caruth v. Commissioner*, 688 F. Supp. 1129 (D. Tex. 1987), *aff'd on other grounds* 865 F.2d 644 (5th Cir. 1989) (finding that section 351 transactions require a business purpose the same as section 368 transactions).



More importantly, the special purpose subsidiaries could merge downstream into P-Co.<sup>108</sup> In the merger, the subsidiaries would disappear, the founding venturers would receive P-Co stock tax free, in exchange for the stock in their respective subsidiaries, and the LLC, which would now have only a single member, would become a “disregarded entity” whose existence would be ignored for tax purposes.<sup>109</sup> For tax purposes, there would be a deemed liquidation of the LLC into its sole remaining member, P-Co.

This hybrid structure can be modified for use by non-corporate joint venturers as well. The exit strategy involving a public offering within the scope of section 351 described above is not dependent upon the corporate status of the venturers and therefore should be equally applicable to non-corporate members. In contrast, the downstream merger exit strategy described above would be unavailable to non-corporate venturers.

A modification of the strategy fashioned after the umbrella partnership real estate investment trust (UPREIT) plan could prove beneficial.<sup>110</sup> Under this structure, the non-corporate venturers would be permitted to exchange some or all of their LLC membership interests, from time to time, with P-Co for P-Co stock. Under this option arrangement, the venturers would be able to recognize their gains piecemeal, as they exchanged their membership interests for publicly traded P-Co stock, which, presumably, they would sell immediately thereafter without incurring further taxable gain.

In addition to providing an exit strategy, the hybrid structure also facilitates use of the corporate stock of a member of the LLC as equity compensation for the LLC’s employees. Regulation section 1.1032-3 permits an LLC that has received its corporate member’s (P-Co’s) stock as an equity contribution to dispose of that stock immediately, without recognizing gain on the disposition.<sup>111</sup> The stock can be used to compensate employees of the LLC without risking a capital shift, which could occur if LLC membership interests in capital were used. Furthermore, Revenue Ruling 99-57,<sup>112</sup> issued on the heels of

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<sup>108</sup>An alternative form of reorganization under section 368 could also be used.

<sup>109</sup>See Reg. § 301.7701-2(c)(2). If it so desired, however, the LLC could elect to be treated as a corporation under Regulation section 301.7701-3(a), (b)(1).

<sup>110</sup>See Russell J. Singer, Note: *Understanding REITS, UPREITS, and Down-REITS, and the Tax and Business Decisions Surrounding Them*, 16 VA. TAX REV. 329 (Fall 1996); John J. Grant, *Tax Planning for Umbrella Partnership REITS*, 21 J. REAL EST. TAX’N 195 (Spring 1994). For a general description of REITs see MCKEE ET AL., *supra* note 82, at ¶ 2.03[1]. The creation of an UPREIT begins with the formation of an umbrella partnership by a REIT and other individuals or partnerships. Grant, *supra*, at 196. Partners in an existing partnership contribute their interests to this new partnership and receive interests as limited partners. Singer, *supra*, at 334. The REIT conducts a public offering of its own shares, the proceeds of which are then contributed to the umbrella partnership. Grant, *supra*, at 196. The REIT acts as the umbrella partnership’s general partner. *Id.* After the initial contributions to the umbrella partnership, the REIT’s “principal asset consists of a general partnership interest,” thereby turning the REIT into an UPREIT. Singer, *supra*, at 335. At some point in the future, the other partners have the option to sell their interests in the umbrella partnership to the UPREIT for its shares or for cash. Grant, *supra*, at 196. With this option to sell their interest, the other partners have the tax advantage of control over when they will recognize any capital gain from appreciated property that they contributed initially. *Id.* at 198.

<sup>111</sup>Reg. § 1.1032-3.

<sup>112</sup>Rev. Rul. 1999-57, 1999-2 C.B. 678.

Regulation section 1.1032-3, extended the available flexibility by holding that if the partnership/LLC transferred the corporate stock to a provider of services to the LLC in exchange for services, only post-contribution gain on the stock would be taxable to the LLC. The tax consequences involving the value of the stock at the time of contribution, that is, the pre-contribution gain equal to the value of the stock less the zero basis, would be allocated entirely to the corporate contributor and would ultimately be tax free to it by virtue of section 1032<sup>113</sup> and Regulation section 1.1032-3.

There are several variations on hybrid transactions both during operations and in pursuing exit strategies, and, therefore, there will be other corporate tax issues that must be considered and risks that must be evaluated.<sup>114</sup> Nevertheless, a hybrid structure involving an operating LLC with corporate equity owners, one of which will be the vehicle used for the ultimate exit strategy, demonstrates the possibilities that may be available to the creative planner.<sup>115</sup>

D. *"The Real Possibilities Are Going Public or Going Under. Either Way, It Happens Quickly and Value of the Loss Pass-Through Feature of LLCs is Likely to be Small."*

At the other end of the success spectrum, it is possible that the enterprise could be a business failure and all or most of the invested capital could be lost. If failure occurs quickly, the decision whether to choose the partnership/LLC structure or to incorporate does not make much difference.

Under a partnership/LLC structure, the excess of deductible expenses over gross income would pass through as an ordinary loss to the partners annually. Any remaining investment of the partners that exceeded their proceeds on liquidation or sale (assuming that only cash was distributed) would be deductible at that time, likely as a capital loss, long-term or short-term, depending upon the particular partner's holding period.

Under a C corporation structure, by contrast, loss is realized by the shareholders only upon disposition, whether by sale (or abandonment) of the stock or the liquidation of the corporation. In general, these events would give rise to capital loss (long-term or short-term, depending upon the shareholder's holding period) with regard to the stock. Individuals may deduct capital losses only to the extent of their capital gains plus \$3,000 per year<sup>116</sup> with the unused capital losses carrying over to future years unlimited in time until the death of the individual taxpayer.<sup>117</sup>

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<sup>113</sup>I.R.C. § 1032.

<sup>114</sup>See Rizzi, *supra* note 108 and accompanying text dealing with the step transaction issue in Revenue Ruling 1970-140, 1970-1 C.B. 73 and Revenue Ruling 1994-76, 1994-2 C.B. 825 regarding the Service's current antipathy to downstream reorganizations involving less than 80% ownership, and resultant no-rule policy.

<sup>115</sup>See B. Penick, *The Emerging Hybrid Structure that Can Best Meet the Goals of Participants in an E-Commerce Start-up*, 79 TAXES 146 (Mar. 2001).

<sup>116</sup>I.R.C. § 1211.

<sup>117</sup>I.R.C. § 1212.

Section 1244, however, provides an exception to that treatment for shareholders who sell or otherwise dispose of their qualifying section 1244 stock at a loss.<sup>118</sup> Those shareholders are entitled to an ordinary loss, which is free from the limitations mentioned above for capital losses. Not all corporate stock qualifies as section 1244 stock. To qualify, among other requirements, the shareholder must be an individual who acquired his stock directly from the corporation. There are also dollar limitations both at time of issuance of the stock and at the time of disposition.<sup>119</sup>

Thus, if there is an immediate demise of the corporation, the shareholders could realize an ordinary loss soon after making their investment (not really a happy event for them, notwithstanding the tax benefits alluded to as a consolation prize), and for the full amount of the investment, if section 1244 applied to all of the shareholder's stock and the loss was within the monetary limitations of the section. Short of complete section 1244 qualification, some or all of the loss may be capital. There is no statutory counterpart to section 1244 on the partnership side.

The more problematic circumstance is the lingering corporation or the "living dead:" those corporations that linger unprofitable for years before being put out of their misery through liquidation. Shareholder loss realization must await a shareholder event of realization, which requires a sale or other disposition (including abandonment) of the stock. Because hope springs eternal and investors are often loath to admit an investing mistake, realization of the losses on the stock could be delayed for several years and the tax benefits that arise from the loss realization could be diminished in present value terms with age.

Thus, the "go public or go under" argument, if it accurately sets forth the likely outcome in a particular situation, has substantial merit. It is this very aspect that makes so troubling the decision to incorporate immediately. It is troubling because it is founded on there being only two likely outcomes and does not allow time or expectation for the building or maturation of a going business. Instead, it carries the air of roulette, or worse yet, the prospects that gain will be generated only under the greater fool theory. Finally, it fails to account for the living dead.

E. *"The Path for Venture Capital Investments in Corporations Is Well Plowed, with Certain Arrangements During Various Rounds of Financing Becoming Standard. To Use an LLC for This Purpose Would Require Reinvention of the Wheel."*

The merit of this argument derives largely from the fact that a venture capital investor focuses much of his interest on the home run exit strategies—the public offering and merger scenarios. The familiar venture capital investment documents therefore contain detailed provisions for conversion of the investor's pre-

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<sup>118</sup>I.R.C. § 1244.

<sup>119</sup>I.R.C. § 1244(b). The maximum amount of ordinary loss permitted for any taxable year is \$50,000 or, in cases of husbands and wives filing joint returns, \$100,000.

ferred stock to common, dilution, and anti-dilution and registration rights, concepts often regarded as relevant only to corporations.

In fact, provision for these eventualities can be incorporated in an LLC operating agreement to mirror the terms of a typical corporate agreement. For example, the LLC operating agreement can provide for classes of units (like stock) instead of percentage interests and governance with a board of directors and corporate type officers such as president, vice-president, and secretary. Also, provision can be made for conversion to a corporation by means of incorporation, pursuant to which classes of units are converted to corresponding classes of stock. In sum, the type of entity used should not necessarily restrict the type of deals that can be struck by the parties. Indeed, in many respects, the LLC allows for greater flexibility than the corporate structure, especially with regard to distributions and the allocation of tax attributes during operations as an LLC.

F. *"Venture Capitalists Are Used to the Corporate Form and Are Largely Unaware of and Unconcerned with the Tax Advantages of LLCs Over Corporations."*<sup>120</sup>

As the economic world changes, the players must adapt. If LLCs offer significant tax advantages over corporations to the owners of those entities, then the market will favor businesses that adopt the LLC structure over those that adopt the corporate structure. Successful venture capitalists in start-up situations will recognize this and presumably gravitate toward that structure. One should therefore expect that over time, the LLC structure will become a familiar one to investors, and the tax advantages will become widely known and sought.

#### IV. CONCLUSION

The principal lesson to be taken from this article is that the choice of entity in a start-up situation should be made with care, taking into account the advantages of each available structure. It is likely that upon full consideration of the issues discussed in this article and the probable short-term and long-term outcomes for the business, the LLC will prove to be the best choice in most start-up situations, particularly where a hybrid structure is not feasible or is too expensive to institute. Even if the LLC structure is chosen at inception and it proves to be inferior to the corporate structure in a particular situation, the parties can change the structure to a corporate one, or a hybrid, with relative ease and cost efficiency. It is this flexibility of the LLC that is one of its most significant advantages. In contrast, it is generally very costly to go from a corporation to an LLC.

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<sup>120</sup>See Bankman, *supra* note 2, which based upon a 1994 Silicon Valley survey, demonstrated this phenomenon years ago.